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America is viewed around the world as sitting atop the pinnacle of a New Economy mountain that other nations will never be able to climb. As I see it, the once sparkling brilliance of Nasdaq has personified what was perfect about the global play into U.S. assets, but now the bloom is off the rose. As Nasdaq fades, investors are coming to grips with the harsh reality that technology may turn out to be a cyclical business after all. This draws into question the mindless extrapolations of earnings growth that had long been embodied in bubble-like Nasdaq valuations.

Stephen Roach, *Global Flash Points: Nasdaq, the Euro and Oil*
Morgan Stanley Dean Witter, Oct. 27, 2000

AFTER US THE DELUGE

In past letters, we have repeatedly warned that people will be shocked at how quickly the U.S. economy's strength will simply disappear once the bull market ends. If it had not been for a burst both in government spending and inventory building, U.S. real GDP growth in the second quarter would have been just 2.8% at annual rate, and if not for another burst in inventory accumulation, it would have been barely 1% in the third quarter. Automobile sales promotions and other temporary factors boosted consumer spending from its sharp downturn in the second quarter. Growth in business capital spending has drastically slowed to 2.9%, after 16% in the first quarter and 11% in the second quarter. Residential building shows an abrupt decline. All signs point to deepening weakness in the economy and, in particular, to a progressive profit squeeze.

From week to week, the gyrations of the stock market are getting wilder and wilder. Still, the trend is unmistakably down. The accelerating decline has been driven by a rapidly growing number of negative earnings announcements and warnings, coming both from the technology sector and from brand-name Old Economy companies. Though hard to reconcile with the GDP figures that suggest a still-booming U.S. economy, all of a sudden profit troubles appear endemic across the whole economy.

The generally favored explanation is the weak euro. We suspect a few other reasons. First, the economy is weaker than suggested by the GDP data; and second, gains in the booming stock market have been a convenient supplementary profit source in the few past years, when profits from current output were wanting. But this source has effectively dried up.

In this letter, we take another close look at the profit performance of Corporate America. According to prevailing percèptions, today's U.S. economy is super-efficient, as shown by the unprecedented productivity growth, recently running at an annual rate above 5%. The other day we read in the *Financial Times*: "By historic standards, the U.S. corporate sector appears to be in good health, but recent phenomenal growth in earnings is decelerating." An enormous technological lead and a supreme entrepreneurial culture are regarded as the secrets of America's outstanding success in boosting GDP and productivity growth. In light of this view, the euro's weakness is commonly attributed to the structural deficiencies deriving from the inefficient European model. In other words, both dollar strength and euro weakness are structural and therefore permanent. This derogatory propaganda about European economic backwardness has been so successful that many Europeans readily confirm this nonsense.

Therefore, in this letter, ~~we~~ thoroughly explore the ~~possible~~ or probable causes of Corporate America's poor profit performance. Ironically, it originates precisely in the two features of the new paradigm U.S. economy that are generally hailed as the key sources of its superior growth and productivity performance. The one is the

shareholder value model, and the other one is the new information technology. Though hard to believe, you will see this verdict rests on sound and plausible economics. In the last analysis, it leads to the disastrous conclusion that the U.S. economy's poor profit performance is conditioned by structural influences.

A PROFITLESS EXPANSION

Please take a good look at the following table. It shows the U.S. economy's effective profit performance over the three-and-a-half years from end-1996 to mid-2000. What you see is mediocre at best. We are sure that the numbers will utterly amaze you because they dramatically differ from the glowing profit picture that Wall Street and corporate ballyhoo have conjured up over these years. Above all, the poor numbers are also completely incompatible with the ebullient GDP and productivity data of the last two to three years.

CORPORATE PROFITS BY INDUSTRY GROUP (IN BILLION DOLLARS)

	1996	1997	1998	1999		1999	2000	CHANGE
			IV*	I*	II*			
Domestic Industries	653.2	723.1	711.5	744.6	772.7	807.4	829.3	26.9%
Financial	144.1	167.5	151.1	156.1	170.6	174.6	169.1	17.4%
Nonfinancial	509.1	555.6	560.4	588.5	602.0	632.8	660.1	29.7%
Rest of the world	100.9	110.7	103.5	111.4	120.5	128.9	134.3	33.1%
Manufacturing	181.2	195.2	177.4	181.6	173.0	193.7	201.8	11.4%
Durable goods	87.0	94.0	85.4	92.2	92.6	94.7	97.2	11.7%
Electronic	20.2	22.8	10.6	12.3	14.3	16.1	16.4	-18.8%
Nondurable goods	94.2	101.2	92.0	89.4	80.4	99.0	104.6	11.0%
Transportation	91.4	85.0	83.9	88.4	101.4	101.9	103.9	13.7%
Wholesale trade	42.6	49.2	56.4	56.7	59.2	61.2	69.7	51.2%
Retail trade	52.9	63.9	76.6	81.5	81.9	90.2	92.4	74.7%
Other	95.2	111.2	112.6	122.3	128.3	127.9	138.7	45.6%

** quarterly numbers are annualized*
Source: Department of Commerce, Survey of Current Business

The numbers in this table, we emphasize, are taken from the official National Income and Product Accounts statistics. To tell you immediately our opinion: The phenomenal U.S. profit performance has never happened, except in the profits that the corporations report after extensive "creative accounting." What the above NIPA figures show is generally pretty poor profit performance under any circumstances. But when you think of the great efficiency and productivity wonders that have been hailed about the U.S. economy in the past few years, this profit performance is abysmal. In fact, it is so miserable that it definitely exposes the prevailing Wall Street and Greenspan hyperbole about the New Economy as complete rigamarole.

Consider: Aggregate U.S. business after-tax profits during these three-and-a-half "new paradigm" boom years have staged a cumulative rise of 26.9%, averaging 7.5% per year. But what is the cause of this poor profit performance?

THE LOW-WAGE ECONOMY

Given the lamentations about the tight labor market, it seems a reasonable assumption that corporate earnings have been squeezed by big wage hikes. There is certainly a lot of talk to that effect. Yet it's another misconception. The truth, rather, is that even during these boom years, U.S. real wage rate hikes have remained at the low end among industrial countries, barely matching the rising inflation rate. ***If there is a productivity miracle, it has clearly bypassed the average American.***

According to Labor Department statistics, ~~real average gross weekly earnings—current dollar~~ earnings divided by the consumer price index—over the 10 years since 1990 have risen by 4.4% altogether, or barely 0.5% per year. Certainly this represents a tremendous improvement in comparison to the two preceding decades,

during which the average wage income of the American worker has, *in real terms*, relentlessly declined, since wage rate hikes constantly lag the increases in the inflation rate. But lately, with accelerating inflation, the long-term decline has returned.

HEAVILY FLATTERED POFITS

We said if you think of Corporate America's alleged productivity miracle, its effective profit performance during these years has been abysmal. Not only that, even these stingy official profit figures have been heavily flattered by at least two major factors. One is the highly favorable impact of employee stock options on ~~corporate profit-and-loss accounts.~~ Though plainly a part of employee compensation, stock options are not charged as expenses to the P&L account. The second extraordinary profit impact is the big capital gains realized in the ~~stock market that have slashed~~ corporate contributions to pension funds to virtually zero, inherently to the benefit of profits.

Which, by the way, has added to the disappearance of personal ~~saving, beca~~use such contributions count as personal saving. Many corporations have even withdrawn substantial amounts from their "overfunded" pension funds. How large has the impact of these two sources of windfall profits from the booming stock market on aggregate profits been? We wouldn't dare to make an estimate. For sure, however, in the past few years they have easily run into triple-digit annual sums and thereby heavily bolstered corporate profits. But please consider further that the end of the capital gains in the stock market essentially implies the end of these two formidable profit sources. Employee options become worthless and companies have to again pay cash into their pension funds.

HIGH TECH IS THE WORST

So much for aggregate profits. Still more interesting are the differences in profit growth between sectors. Which sector do you think has performed best in regards to profits, and which one has performed worst? The top profit performer by far, obviously reflecting the consumer borrowing and spending binge, has been retail trade, with a stellar overall profit gain of 74.7%, followed by wholesale trade with a gain of 51.2%. The worst performer has been manufacturing, showing an increase in overall profits by just 11.4% for the same period, averaging 3.4% per year. But note that all of this profit increase in manufacturing occurred in the first half of 2000.

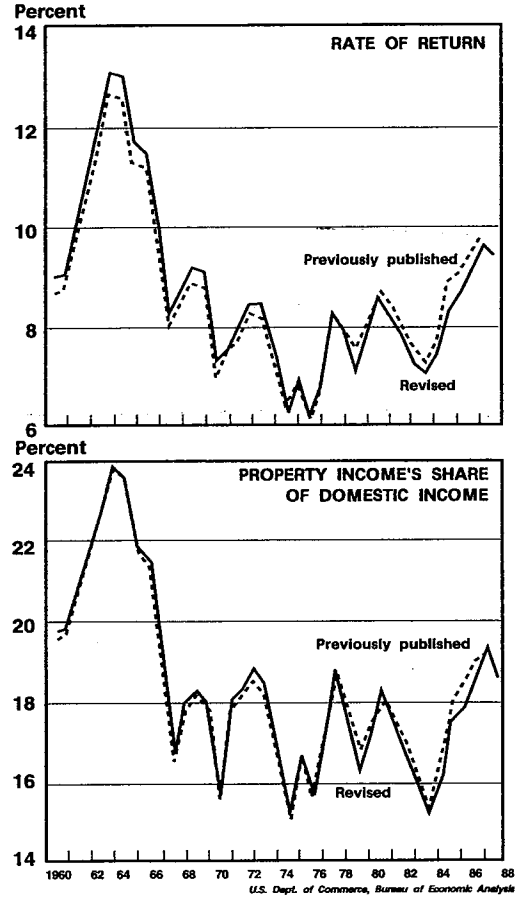
Within manufacturing, one sector stands out as an outright profit disaster, and this happens to be the branch where the production of the New Technology is centered: electronic and other electric equipment. With a sharp decline in its profits of 18.8% during this period, this sector had far and away the worst profit performance in the whole economy. The sector's total earnings of $16.4 billion, by the way, account for 2.5% of total profits of nonfinancial corporations. Please note further that profit growth in Corporate America's foreign affiliates has been three times as high as profit growth in domestic manufacturing—33.1% versus 11.4%.

Scanning the U.S. profit development, we realized long ago two important things: first, today's extent of profit manipulation through stock options, stock buybacks and other accounting gimmicks is unprecedented in history. Second, despite all the creative accounting, the rates of return recorded by the NIPA accounts are anything but impressive. They are far below their level in the 1960s and only moderately better than the bad averages of the 1970s and 1980s. There is definitely no profit boom. Taking the massive accounting gimmicks into account, it rather looks like profitless prosperity.

Don't be irritated by the term "Property Income." It embraces the two components of capital income from domestic nonfinancial corporations: *profits plus net interest income*. Pure profits from current production in the late 1990s accounted for a little more than 15% of national income. This was well above its depressed share in the 1980s, but far below its share in the 1960s. The rate of return on "produced assets" in the last three years has

averaged about 7.6%. This rate, too, was well above its levels in the 1970s and 1980s, but far below its levels in the 1960s.

Rate of Return and Property Income's Share of Domestic Income, Domestic Nonfinancial Corporations, 1960-98



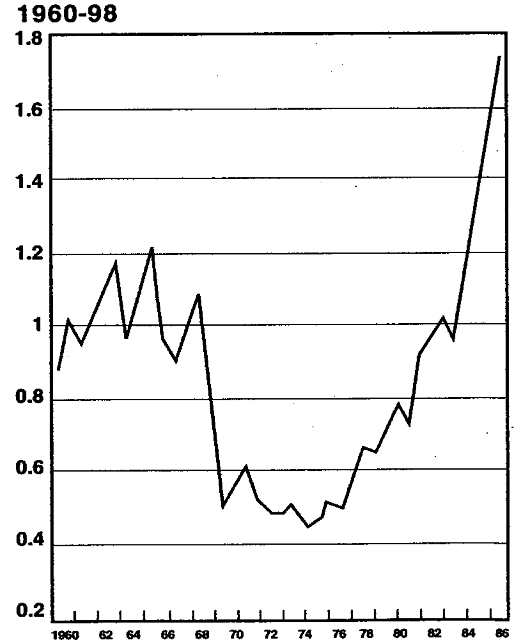
HOW OVERVALUED?

The same article in the Survey of Current Business contains a third chart, which describes the so-called *Q* ratio, pioneered by Professor James Tobin. The idea behind this ratio is very simple. It compares the value that the stock market puts on total outstanding corporate shares with what it would cost today to replace all existing corporate assets, both physical and financial, minus their liabilities. This estimate is generally referred to as net worth.

Inherent to this ratio is an important conclusion concerning corporate policy. A value of *Q* above 1 indicates that buying existing plants through the stock market costs more than to build a new plant. Alternatively, a value of *Q* below 1 indicates that it is cheaper to buy existing plants than to build new ones.

We have reproduced this chart for two reasons: first, in order to show that the market valuation (*Q* ratio) of total U.S. stocks at the end of 1998 was far higher than at any previous time. Much lower peaks in the past century occurred in 1929 and in 1969. Secondly, given the record-high market valuation of U.S. stocks, it appears extremely odd that U.S. corporations have been pouring hundreds of billions of owned and borrowed dollars into the purchase of outstanding stock, either to acquire other companies or to purchase their own stock, although their market valuations are generally vastly in excess of the replacement costs of the underlying capital assets.

Q-TYPE RATIOS, DOMESTIC NONFINANCIAL CORPORATIONS, 1960-98



From a strict economic perspective, it is hard to imagine a greater economic folly than buying low-yielding equity capital with much higher-yielding indebtedness. But in a world where managers' incomes are effectively linked to what is currently happening to stock prices, there is a very strong incentive to put the instant maximization of shareholder value over any other consideration, regardless of foreseeable, adverse micro and macroeconomic consequences in the longer run. It's the policy of the desperado who has everything to gain in the short run and nothing to lose in the long run.

In the case of acquisitions and mergers, the popular buzzwords to justify them are future "synergy" effects through cost-cutting in the larger, combined entity. Everybody is full of praise. Investors in the takeover target are thrilled to see their stock run up fast. However, the regularly-promised big efficiency gains have very rarely, if ever, materialized. As a rule, the shareholders of the acquiring companies are the great losers

in the longer run. Just think of Daimler-Chrysler. But the lure of expected short-term effects on stock prices and the associated favorable publicity seem irresistible to the ego of many managers.

Look at the profit table again. Consider that effective overall corporate profit growth has been 26.9% over the whole of the three-and-a-half boom years. This compares with the present schizophrenic consensus expectation of 25% earnings growth per year. Somebody has planted these absurd profit expectations into people's minds. Wall Street, of course, is one. The other one in particular is Mr. Greenspan, with his endless talk of a growth and productivity miracle. Always being told that the U.S. economy is enjoying unprecedented productivity wonders, it is perfectly logical for people to look for unprecedented profit wonders in its wake.

SYSTEMATIC DELUSION

But how is it possible that this poor profit performance over several years has not disillusioned people at all? The short answer is: They have not become disillusioned because they don't know. Wall Street has taken care of that problem by devising ways and means to present the corporate profit reports in such a way as to assure maximum obfuscation of investors. First of all, it shifted the focus of attention away from aggregate profits and towards earnings per share. Second, it replaced objective comparisons with prior profits by elevating expected profits to the decisive measure for reported profits. Meanwhile, everybody knows how this worked. Analysts became increasingly *guided* by management to put the latch of "expected" profits low enough for the reported profits to show a gain—frequently of just one penny.

At long last, the Securities and Exchange Commission has prohibited such "selective" disclosures. Although not yet in effect, the new rule nevertheless seems to work already. In new fashion, the stock market lately reacts dramatically to any disappointing corporate news which, despite the stellar growth numbers for GDP and productivity, are abounding all of a sudden. Some people attribute this radical change in market behavior to the altered disclosure rules. Bear in mind that Wall Street has drilled people to believe that only *unexpected* news tends to affect the market. Expected bad news counts for little by this rule. In the past, corporate management discretely prepared a few analysts for coming bad news who, in turn, readily prepared the public for it, ensuring that the market would never be disturbed by "unexpected" bad news. All of a sudden, now, unexpected bad news is proliferating and hammering the market.

And why do you think Wall Street has chosen to narrowly concentrate market attention on per share earnings as the all-important profit gauge? First of all, it distinctly puts the focus on shareholder value. But more important and highly dubious is a further effect. It instills a strong bias into corporate financial management toward debt financing at the expense of equity financing. Most probably, this is a desired implication. The outcome is well-known. Corporate America has embarked on the most reckless leveraging of its balance sheets. Cutting the equity base intrinsically raises per share earnings which, hopefully, tends to raise shareholder value. While shrinking their equity base by acquisitions, mergers and stock buybacks, nonfinancial corporate businesses since 1995 have swelled their debt within this short span of time from about $6 trillion, of which a very large part is short-term.

UNPRODUCTIVE DEBT

Wall Street likes to justify the corporate stock buybacks by arguing that it is the best way to make use of available cash. Like so many distinctions of the shareholder value culture, this one, too, is badly flawed. It begins with the fact that the available cash needed to pay for the stock buybacks does not exist. After paying out dividends and covering their investment expenditures, the U.S. corporate cash flow overall is in the red. So in reality the huge stock repurchases have to be financed by borrowing at interest costs that are generally several times higher than the rock-bottom equity yield. How can a corporate manager in his right mind do this?

Well, it's the difference between short-term and long-term effects. From a long-term perspective, this policy of replacing extremely low-yielding equity with high-yielding debt is a complete folly to any reasonable person. Rapidly compounding interest costs on the escalating debt ratio are inexorably squeezing corporate profitability in the longer run, showing in a rising share of interest payments to available earnings. If you think of this effect, you will understand Mr. Greenspan's extreme reluctance to raise interest rates.

To repeat, from a long-term perspective this reckless pursuit of debt financing is, clearly, economic insanity. But the all-important point to see is that the shareholder value concept, implicitly, has zero interest in what happens in the long run. The dictatorial request of maximizing shareholder value essentially applies to *present value,* not to a firm's value in five or more years. For good reasons, this short-term orientation of the shareholder value philosophy is never mentioned, yet it is compelling

IBM is a case study of how to delude investors. *Barron's* (July 3, 2000, Alan Abelson) showed how this practice of financial gearing has worked wonders on IBM's per share earnings. Over the last four years, Big Blue has managed to increase its revenues by a modest 5% and its gross profits by an even more anemic 1.3%. However, thanks to a massive $34 billion share buyback program, it managed an average annual rise of 10.5% in the one number that Wall Street treasures above all others: per share earnings. Meanwhile, the debt ratio went skyward.

Another issue of paramount importance is, of course, the origin of the "wall of money" piling into the U.S. financial markets. It definitely doesn't come from non-existent savings. From what then? There are but two possible sources: credit and money creation, or a flight of investors out of cash balances and into financial assets. It was, in fact, a combination of both.

As we have described many times in past letters, the credit expansion in the United States during the past few years defies all reasonable description. Relative to the economy's productive capacity, it was monetary policy running amuck.

BELEAGUERED CONSUMER

In the last letter, we pointed out that real personal income growth has ominously collapsed in comparison to the still stellar real GDP growth. According to latest corrections, real disposable income in June and July each crept up a mere 0.1%. August surprised a bit on the upside with a gain of 0.3%. By no means, though, did this improvement in real income growth reflect any acceleration in nominal income growth. The key factor—you won't believe—was the largest *seasonally-adjusted* decline in energy costs since 1991. Gasoline, for example, fell fully 6%, leading to the first monthly decline in the CPI in 14 years.

In August, the personal saving rate made a new record-low of -0.4% of disposable income. Yet its rate of shrinkage has sharply slowed. It strikes us as most ominous that in the face of virtually stagnating real disposable personal incomes, any further rise in consumer spending now depends fully on further consumer dissaving. How long do you think the consumer will be willing and able to sustain this pattern, particularly against the backdrop of negative wealth effects in the stock market? Another two or three months perhaps?

That's why we think it's time to brace for a rapidly approaching hard landing. And please also weigh that if a booming and super-productive U.S. economy is generating such dismal real income growth, what is going to happen when recession arrives?

BEGGAR–THY–CHILDREN CAPITALISM

Since the consumer was faltering, the markets needed a new bull story. Wall Street quickly concocted it: The U.S. economy has shifted from consumer-led to investment-led growth. Just imagine: non-residential, fixed investment in the second quarter of 2000 accounted for 35% of overall real GDP growth. And that, by the way, with negative personal savings.

Frankly speaking, this is an absolutely ridiculous statistical picture. Also keep in mind the proliferating profit warnings and the virtual stagnancy of real disposable consumer incomes. It's a picture in which everything is grossly at variance with everything else.

The best way to understand and explain the cause or causes of this disappointing profit performance starts with a brief recollection of what, in effect, chiefly determines an economy's profit performance. Putting it as briefly and succinctly as possible: It's the difference between business revenues and business expenditures.

With this simple recognition in mind, we have a shocking statement to make: The U.S. economy's weak profit performance during the 1990s is by no means just ephemeral and fortuitous; it is endemic and structural. And this miserable failure in profit creation has two chief causes that are easy to recognize. Ironically, it originates precisely in the two features of the U.S. new paradigm economy that are generally hailed as the key sources of its superior growth and productivity performance. The one is the shareholder value model, and the other one is the new information technology. The old economists would have said, both are anti-capitalistic.

The conspicuous peculiarity of the shareholder value model is its enthrallment with corporate restructuring. Basically, restructuring is a vague euphemism for all kinds of measures that tend to enhance shareholder value *in the short run*, virtually to the exclusion of any other goal.

The plain result is that American corporate management favors such policy measures that appear most promising in raising shareholder value in the short run. One is a thrust towards financial engineering, including acquisitions, mergers and stock buybacks. The other one is an unprecedented thrust towards cost-cutting and downsizing. The essential flip side to this shift in corporate strategies is a bias against long-term investment. Potential rates of return in the real economy compared poorly with the returns that the financial markets offered.

In the January letter, we posed the question: What kind of capitalism is there really in the United States? Our answer: Far from being a new and more efficient capitalism, it is "late, degenerate" capitalism. The essence of classic capitalism was long-term oriented capital accumulation out of savings, and there was a strong sense of responsibility of heritage for future generations.

What is the essence of this neo-American model of capitalism of the 1990s? A frantic chase of corporate management after quick and easy profits in the stock market through deal making and stock buybacks, a dissaving public and unfettered credit creation by the financial system for consumption and speculation. The responsibility of the corporate manager under this "new" capitalism begins and ends with the near-term stock price.

It's late, degenerate capitalism in the sense that saving and capital accumulation, the key features of a capitalistic economy, have fallen into complete oblivion. Worse still, it is a capitalism which any educated nation should be ashamed of because the corporate strategies that result from the single-minded microeconomic logic of maximizing present shareholder value inherently impart increasingly negative long-term macroeconomic consequences to economic growth, income and profit creation. What really happens is rampant over-consumption at the expense of future generations who are to inherit depleted domestic capital formation, a mountain of foreign indebtedness and lots of worthless paper assets (stocks and bonds). It might

be called "beggar-thy-children capitalism." The motto of this capitalism is "After us the deluge."

WHAT MAKES AND WHAT KILLS PROFITS?

Now to the profit performance of this new capitalism. To repeat the obvious: All revenues increase profit, and all expenses reduce profits. In general, corporate management has always operated on both sides of the equation. But historically, the emphasis in the pursuit of profit has always been on building new, evermore efficient and productive plants and equipment. The high rating that cost-cutting enjoys under the shareholder value regime has no precedence in the history of capitalism.

But doesn't the U.S. economy also have a very high investment ratio, the highest among industrial countries? Since 1996, it has been in the order of 38% in real terms and 27% of GDP growth in nominal terms. But this capital spending boom has been dominated by one single item: computer hardware and software. In real terms, the two together accounted for 62% of total fixed investment during this period and for 30% in nominal terms. Business purchases of computers more than quadrupled in "chained" (1996) dollars from $70.9 billion to $298.5 billion versus an increase in current dollars from $70.9 billion to $114.2 billion.

Some other remarkable features of the investment boom to note: *Industrial* building in 2000 is slightly below its level in 1996, while office building has increased 67%. The strength of spending on computers that started in the early 1980s is consistent with an ongoing shift away from goods-producing manufacturing toward services, in particular toward retailers and financial institutions. Investment in manufacturing over the whole period has risen just 8%. Lots of reasons speak for the assumption that all of that, if not more, was in high-tech. Outside of that small sector, new investment is at best stagnant. Considering the miserable profit performance of manufacturing—see the table on page 2 again—this reluctance to invest is easy to understand.

Now to the verification of our earlier heretic statement that the U.S. economy's poor profit performance originates primarily in the over-emphasis on pursuing quick profits through restructuring and financial engineering. What the apostles of this shareholder value rigamarole have never grasped is the fact that their micro-logic flagrantly violates macro-logic.

MACRO VERSUS MICRO

Everybody speaks in awe of the great "restructuring" efforts and successes that Corporate America has achieved in accordance with the shareholder value rules. Our radical disagreement with this view begins with a look at the NIPA figures that show a profit performance that in reality is rather poor. And we hasten to add: This dismal result has its overriding cause in the circumstance that restructuring, with its emphasis on cost-cutting and downsizing, is completely unsuited to boost overall profits. This idea suffers from the so-called fallacy of composition: What benefits a single firm can be harmful to firms as a whole. If one firm cuts wages, it is able, *ceteris paribus*, to enhance its profitability; but once most firms follow suit, the result is very different and the problem remains unsolved because overall cost cuts implicitly cut overall spending power and thus business revenue as well.

Assessing the movement of aggregate profits requires a strictly macroeconomic perspective. Changes in profits reflect many different decisions in the economy as a whole. Decisions to save, invest, borrow, tax, import and so forth, involving flows of funds into and out of the business sector. All business expenses reduce profits, and all revenues increase profits. In seeking the sources of aggregate profits, we focus on the particular flows that directly impact aggregate profits of the business sector. We must distinguish this flow from all intra-business sector transactions which affect the distribution of profits between individual firms but have no impact on aggregate profits.

The most important profit source in a capitalist economy is, as a rule, capital investment, and that only. The

extraordinary importance of current investment spending for the generation of aggregate profits arises from the fact that it creates immediate business revenue without generating immediate business expenses. When a corporation builds a factory, the expenditures are capitalized in the balance sheet. No expense is incurred until the first depreciation charges enter the P&L account. Remember, we are looking at the business sector as a whole.

Yes, but doesn't the U.S. economy have a record-high investment ratio? Why, then, is the profit performance so poor? There are two main reasons: the hedonic deflator and the soaring trade deficit.

Think of the two figures, mentioned in previous letters, computer investment between end-1996 and mid-2000: up $43.3 billion in current dollars, up $227.6 billion in chained dollars. Which of the two numbers brings profits to the business sector? Only the $43.3 billion, being the amount that was actually spent by computer buyers and actually received by computer producers. The $227.6 billion, measured in chained dollars, add magnificently to real GDP and to productivity growth in line with it. But apart from the $43.3 billion spent in current dollars, these chained dollars, resulting from collapsing prices, are phantom dollars that nobody pays and nobody receives. And for this reason, we regard this practice of generating real GDP growth by a collapsing price index as complete economic nonsense. We expect one of these days to hear these statisticians claim that the Great Depression never happened because prices back then fell faster than nominal GDP.

When computers are stripped out of the investment ratio, the rest is mediocre at best, in particular for a booming economy. The economic growth has come from the consumer spending boom fueled by credit excess and (as a consequence) booming stock and property values. Total investment rose in response to the strong stimulus from consumption, but it was largely confined to two consumer-related sectors: retail and finance. Manufacturing investment has hardly recovered from its lows in the 1980s.

We come to the unrecognized, relentless big profit killer in the U.S. economy. As past letters repeatedly have pointed out, that's the soaring import surplus, presently running at well over $400 billion per annum. In essence, it reflects a money flow that exits the U.S. income circulation for foreign producers and their wage earners. Importantly, a large part of this money flowing out through the trade balance comes from Corporate America's wage bill. But unlike wages paid that return as revenue via the purchase of U.S. goods and services, money spent on imports is definitely lost to U.S. producers. A large and growing trade deficit, implicitly, ravages business profits.

We now move to the profit rebound in 1999-2000. The consensus readily ascribes it to the trumpeted productivity miracle. But looking at the flows of funds that enlarge business revenues and profits, the main cause of this recent profit recovery is easy to identify. It is the product of a new burst in consumer profligacy resulting in the complete collapse of personal saving. To give an idea of the enormity of this influence: Personal saving plunged in this very short time span from $265 billion in late 1998 to -$40 billion, at annual rate, in August 2000.

Note the critical difference between the sources of finance for consumer spending: wage-financed versus credit-financed. The latter implicitly translates into a corresponding increase in profits because it is money that has involved no business expense. Remarkably, this literal collapse of personal savings occurred on the heels of the Fed's three rate cuts in the autumn of 1998 in response to the Asian-Russian crisis.

PRODUCTIVITY IS NOT EVERYTHING

"Ultimately, the economic debate boils down to productivity, the benchmark of any economy's ability to create wealth, sustain competitiveness and generate improved standards of living." This wisdom is from a well-known American economist. We quote it because we regard it as one of the great fallacies in the thinking of many economists in America.

We can put our diametric disagreement into a simple statement: ***Rising prosperity and rising living standards do not come from existing factories, but from building new factories. It's not productivity that creates wealth; nor is there such a thing as a productivity-led expansion. It's spending, and spending alone, that propels economic growth. But it's the kind of spending that makes all the difference. Credit-financed consumer spending or credit-financed investment spending, that's the question. An economy's wealth has but one source: the confluence of saving and investing which, together, are also the most important source of productivity growth. Not vice versa.***

As a matter of fact, more than anything else it is this recognition of the all-important role of investment spending and capital formation in generating solid, profitable economic growth and prosperity that long ago made us highly critical of the potential profitability of the new information technology. True, we see virtual technological wizardry, yet where are the profits and the prosperity of this technology, except in the stock valuation? Neither will they materialize in the future, and the reasons for that failure lie in the various, specific characteristics of this technology.

The wealth effects of the free enterprise capitalism have always accrued in the economies through the building of factories. The wealth effects of the "new" American capitalism have accrued overwhelmingly in the stock market, fueling the most reckless consumer borrowing and spending binge in history.

THE SOLE KEY TO PROSPERITY: CAPITAL FORMATION

The new information revolution has been sold to investors as a technology that will do the greatest wonders to productivity, profits and wealth, far more than the industrial revolution has done. During the past few years, it has worked marvelously—in the stock market. The general idea behind the unfolding euphoria was and still is that this technology is able to deliver almost limitless growth and productivity effects because its implementation requires very little input of capital and resources. Rapidly growing demand for the new technology has met supply growing just as rapidly.

It is true, indeed, that the implementation of the new information technology requires incomparably less capital input than the industrial technology did. Never before has it been so easy to multiply capacity so quickly. Many see in the new technology the magic wand that conjures away the scarcity of savings and of capital goods, heralding a world of plenty for America and the world. But the great irony about this technology is that its alleged, unique advantage of minimal capital input is the very reason for its inherent inability to create prosperity and profits.

Deeming the minimal capital input, intrinsic to the new information technology as a great economic advantage, is another gross misconception. Capital input is a synonym for capital formation, and capital formation is really at the bottom of everything that matters in creating prosperity. Representing the surplus of production over consumption, it is the one and only source of macroeconomic wealth creation. At the same time, the building of factories and the production of equipment create jobs and incomes in the capital goods industries and among their suppliers. Owing to these effects, capital formation is strategic for generating general prosperity.

We come to the stunning contrast in economic implications between old industrial and new information technology. It was the distinguishing feature of the industrial technology that its implementation required extensive capital investment. In fact, this was precisely what conditioned the extraordinary dynamism of this technology and its notable propensity to create wealth and profits. Rendering rising revenue, income and profits, the tangible assets that accumulate in the corporate balance sheets provide, in turn, the perfect collateral for external financing. Remember our earlier remark that, from a macroeconomic perspective, net fixed investment in a healthy economy is the largest and most important profit source, because the plant and equipment expenditures are capitalized and gradually written off against the future earnings of these assets.

Sorry for this boring, detailed description of the intricacies of wealth and profit creation under the industrial technology. But this knowledge is necessary to understand why the new information technology badly lacks all these indispensable qualities for its long-term success.

THE NEW ECONOMY DESTROYS CAPITAL

Now to the macroeconomic dynamics of the new information technology. To say that it involves massive malinvestments would be a gross understatement. The truth is much worse: It involves massive capital destruction. The other day, a Merril Lynch economist was quoted to have said: "The Internet has created more value more quickly than any other technology trend we know of." According to another argument, even after the stock market decline, the market value of the U.S. Internet sector is still $800 billion. Views of this kind are probably widely shared in America.

The first great myth to debunk is that soaring stock prices represent valid wealth creation for the economy. They do so, of course, for the stockowners. From a macroeconomic perspective, though, an economy's total wealth is in its capital stock of structures, equipment and inventories. And essentially, this capital stock can only increase to the extent that production exceeds consumption.

Manifestly, rising stock prices add nothing to an economy's capital stock. What they create is the exact opposite: soaring claims on the part of the stockowners on the national product and its capital stock. In practice, the booming stock market of the late 1990s has furnished stockowners with virtually limitless actual and potential purchasing power, and as a rule, this happens to stimulate borrowing and spending. Asset price bubbles, thus, typically lead to significant resource misallocation. Japan's bubble in the late 1980s fueled a huge increase in corporate borrowing for investment spending. Currently in the United States the equity gains have had their biggest impact on consumer borrowing and spending, as reflected most strikingly in the literal collapse of personal saving. As less resources remain available for new investment, such a switch in the use of resources ranks in economics as "capital consumption."

But doesn't the U.S. economy also have a rampant investment boom? Again taking measure of the three-and-a-half years from end-1996 to mid-2000, fixed investment accounted for a stunning 38.8% share of real U.S. GDP growth. If you keep in mind that capital formation is the saved portion of GDP, this recorded investment ratio is plainly a statistical absurdity, and its source is easy to spot. No less than 82.6% of this total has been in high-tech investment. But by far the single biggest component within this total is investment in computer hardware. As measured by hedonised, chained dollars, it accounted for 40% of total fixed investment and for 15% of real GDP growth. Including software, the two numbers would be 62% and 24%.

We stick to our view that measuring investment in computer hardware this way is grossly misleading. From a strictly economic point of view, the one thing that solely matters for business revenues and profits are the current dollars they spend and receive. By this measure, though, computer hardware investments remain a minor item in the economy. During the three-and-a-half years under review from end-1996 to mid-2000, its increase by $43.3 billion accounted for 7.5% of total fixed investment and for 2% of GDP growth. And this fragment is supposed to have done all the hailed miracles to the U.S. economy.

And what about capital formation by the users of the new information technology? Take, first, the telecom companies. They have tapped global stock and bond markets over the past few years for trillions of dollars in order to spend the proceeds… on what? On capital investment in the infrastructure of the new technology? Yes, but far greater, mind-boggling sums of money went for two other purposes that have nothing to do with capital formation: the aggressive purchasing of new customers at fantastic prices through the acquisition of rivals, and the well-publicized horrendous payments on license fees for third-generation UMTS ventures.

Essentially, the telecom firms have to capitalize these huge expenses in their balance sheets as "assets" that

have to be written off over the next 10-20 years. In principle, this is the apparent parallel to what businesses in the Old Economy do with their investment spending to implement the industrial technology. But please consider what the telecom firms have actually piled up on the asset side of their balance sheets as counterpart to their exploding liabilities: In essence it's capitalized costs, sheer costs earning nothing, qualifying their liabilities overwhelmingly as unproductive debt. For good reasons, the outstanding debts rank, after all, as junk bonds.

And what about Internet firms' impact on capital formation? They, too, have tapped the stock and bond markets for mind-boggling sums. In their case, the bulk of the amassed cash balances went for two purposes that definitely belong to the Old Economy: inventories of the goods offered for sale and massive advertising to attract new customers. One by one, Internet companies are running into financial trouble as their extensive spending on advertising virtually "burns" their cash balances. But bear in mind these cash balances have not come from current revenue or cash flow. They have directly accrued from the stocks and bonds that these companies have issued. They are not just burning cash, but their accumulated capital.

CONCLUSIONS:

The U.S. economy is already far weaker than most people realize because they fail to see that the good-looking GDP numbers for the second and third quarter have been heavily propped up by record-high inventory building. When that stops, recession will hit.

Economic imbalances and financial excesses of unprecedented size have made the U.S. economy and its financial system more vulnerable than ever before. There are serious problems everywhere: in the credit markets, in the banking system, in stock valuations, in credit availability, in the profit performance, in the debt burdens of corporations and consumers, in negative personal savings, and in the huge trade gap and the grossly overvalued dollar. Confidence in the dollar has been the one linchpin that has held this disintegrating system together.

High saving and heavy capital accumulation were paramount in boosting wealth and living standards in the course of the Industrial Revolution. For too long have too many people believed that the new information technology offers a free lunch by delivering huge gains in equity prices. In reality, this paper wealth creates the exact opposite: financial claims on existing resources.

Hopes for a soft landing of the U.S. economy are completely misplaced. We have witnessed the worst financial bubble in history. Just as misplaced are the hopes that Mr. Greenspan will again save the day by promptly opening the Fed's money spigots. Regard for the dollar will constrain his scope for action in the first place, and the need for painful balance sheet adjustments on the part of heavily indebted consumers and corporations will severely impede the effectiveness of monetary easing in the second instance.

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